ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Scott	Analyst: Marion Mann DeJong	Bill Number: AB 1467	
Related Bills: SB 1229	Telephone: 845-6979	Introduced Date: 02/26/1999	
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SUBJECT: Water's-Edge/FTB Follow IRS Profit Split Rules For Audit

SUMMARY

This bill would provide that the Franchise Tax Board (FTB) would be presumed to have followed rules, regulations and procedures for transfer-pricing audits when corporations in a water's-edge group elect to use the profit split method with respect to Section 936 of the Internal Revenue Code. In addition, it would be presumed that the allocation of combined taxable income under the profit split method clearly reflects the income of the members of the water's-edge group and clearly reflects the income of the electing corporation.

EFFECTIVE DATE

This bill would become effective on January 1, 2000, but the bill does not specify the manner in which it is to be applied.

SPECIFIC FINDINGS

Under current federal law, corporations organized in the United States (U.S.) are taxed on all their income, regardless of source, and are generally allowed a credit for any taxes paid to a foreign country on their foreign source income.

Under current federal law, foreign corporations engaged in an U.S. trade or business are taxed at regular progressive U.S. rates on income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income or ECI. However, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on certain income (usually investment income) from U.S. sources.

Federal law uses the "separate accounting method" to determine the amount of a corporation's income subject to tax. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not subject to tax within the taxing jurisdiction.

The separate accounting method is generally premised upon the use of "arm's-length" pricing in transactions between related parties. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties. However, in many situations related corporations may realize an overall tax benefit for the affiliated group by shifting income between affiliates and not charging an "arm's-length" price.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
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____ N	____ OUA	X PENDING	**Gerald Goldberg**	**4/16/1999**

Internal Revenue Code (IRC) Section 482 was enacted to prevent any arbitrary shifting of income between affiliates. The Internal Revenue Service (IRS) conducts Section 482 audits to determine if the related parties have charged an "arm's-length" price and, if not, what the "correct" price should be. This is commonly referred to as transfer pricing.

Under federal law, in determining the Puerto Rico and possession tax credit, a possession corporation[1] may elect to attribute some of the income from intangible property[2] to the U.S. corporation by use of either the cost sharing method or the profit split method. If neither method is elected, virtually all of the income attributable to the intangible property is considered U.S. source income. Thus, a possession corporation is treated as a contract manufacturer not owning any intangible property, even if the intangible property was purchased from unrelated parties or developed by the possession corporation itself.

The Puerto Rico and possession tax credit is terminated for tax years beginning after December 31, 1995. However, special phaseout rules apply in the case of existing credit claimants[3]. Existing credit claimants may continue to claim the credit throughout the last tax year beginning before January 1, 2006. For tax years beginning in 2006 and thereafter, the credit it scheduled to expire.

If the cost sharing method is elected for **federal purposes**, the possession corporation is required to pay its affiliates for its share of product research and development costs incurred by the affiliates during the year. The cost share payment cannot be less than the cost share payment that would be required under IRC Section 482.

If the profit split method is elected for **federal purposes**, the taxpayer is permitted to arbitrarily attribute 50% of the manufacturing profits (for the product lines covered by the profit spit method) to the possession corporation. If the federal profit split amount reportable by the possession corporation is less than the amount of net income reported by the possession corporation on its books, the possession corporation will usually remit a payment to the U.S. shareholder. If the reverse occurs, the U.S. parent corporation remits a payment to the possession corporation. Procedurally, the IRS does not conduct Section 482 audits of corporations electing the profit split method in determining the Puerto Rico and possession tax credit and treats that method as properly reflecting the income of the electing corporation.

Under current California law, California source income for corporations that operate both within and without the state is determined using the unitary method of taxation. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the

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[1] Possession corporations are U.S. incorporated entities located in U.S. possessions, most notably Puerto Rico, which have elected the benefits of Internal Revenue Code Section 936.

[2] Intangible property includes patents, inventions, copyrights, trade names and trademarks.

[3] An existing credit claimant is a corporation that was actively conducting a trade or business in a possession on October 13, 1995, and that had a Code Section 936 election in effect for the corporation's tax year that included October 13, 1995. A corporation can also qualify as an existing credit claimant if it acquires all of the trade or business of an existing credit claimant.

total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The fundamental difference between the worldwide unitary method and the federal separate accounting method discussed above is that the prices or charges on transactions between related parties are simply disregarded under the unitary method, as opposed to adjusted under separate accounting rules.

As an alternative to the worldwide unitary method, **California law** allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. Therefore, in a water's-edge combined report, the allocation of income between affiliated corporations, some of whom are members of the water's-edge group and some of whom are not, is relevant to the correct determination of income from California sources.

Generally possessions corporations are excluded from the water's-edge combined report group, unless:

- the possessions corporation's average United States factor is equal to 20% or more; or
- the possessions corporation earns U.S. source income which is effectively connected with a U.S. trade or business, and if the possessions corporation is considered a taxpayer for California purposes.

California law requires the department to conduct transfer-pricing audits (Section 482 audits) to ensure that taxpayers include the correct amount of income in the water's-edge combined report. The department is not required to perform an audit if the IRS is examining the taxpayer for the same year or years on the same issues. If the IRS does conduct a detailed Section 482 audit, **California law** specifies that it shall be presumed correct and that the results of the federal audit apply for state tax purposes. This presumption can be overcome if either the FTB or the taxpayer demonstrates that:

- An adjustment or the failure to make an adjustment was erroneous.
- The results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons.
- Substantially the same federal tax result was obtained under other IRC sections.

If the IRS does not conduct a Section 482 audit of any particular taxpayer, **California law** specifies that no inference shall be drawn for state purposes from this failure.

California law does not conform to the IRC Section 936 elections relating to the profit sharing or profit split methods used in computing the federal Puerto Rico and possessions tax credit. For **California purposes**, IRC Section 482 governs the relationship between a possession corporation and the U.S. affiliates.

This bill would provide that the FTB would be presumed to have followed rules, regulations and procedures of the Internal Revenue Service in conducting Section 482 audits when two or more corporations elect to use the profit split method (under IRC Section 936). In addition, it would be presumed that the allocation of combined taxable income under the profit split method clearly reflects the income of the taxpayer or taxpayers in the water's-edge group and clearly reflects the income of the electing corporation. Thus, **this bill** would essentially allow use of the profit split method for California purposes.

Policy Considerations

Section 482 (transfer-pricing) audits are very resource-intensive and taxpayer intrusive. For this reason, California is not required to conduct a Section 482 audit if the IRS has conducted such an audit. Presuming that the Section 482 requirements are met when a taxpayer elects the profit split method for federal purposes under Section 936 would reduce the number of Section 482 audits the department is required to conduct.

Since it appears that the author intends for the profit split method to be used instead of transfer-pricing for taxpayers that make the federal election, the author might consider making the taxpayer's federal election binding for California purposes.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- This bill does not specify when its provisions are to be operative. Since the bill would specify audit practices and not change the computation of taxes, the general rules that would make it applicable to income years beginning on or after the effective date of the bill may not apply. Further, the bill could be interpreted to apply to audits in progress as of the effective date, and thus apply to all open years.

- It appears that the bill is intended to require the department to accept the results of the profit split method of assigning income to the U.S. and thus the water's-edge group. However, the language of the bill is ambiguous in some respects and could lead to disputes between taxpayers and the department. For example, the bill does not specifically conform to the profit split method or require the federal election to be binding for state purposes. Thus, it is not clear how the bill would apply to corporations that elect to use the profit split method for federal purposes, but which claim that they are not bound by the federal election for state purposes. Further, it is unclear whether the department would be required to audit the transfer pricing issues related to that taxpayer and any related taxpayers pursuant to IRC Section 936 or IRC Section 482 when no federal audit has occurred.

FISCAL IMPACT

Departmental Costs

To the extent that this bill simplifies transfer pricing audits and reduces disputes between taxpayers and the department, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 1467 As Introduced 2/26/99 [$ In Millions]		
1999-00	2000-01	2001-02
($4)	($8)	($7)

Estimates assume the bill would be effective January 1, 2000, with enactment after June 30, 1999, and would apply to all years for which the statute of limitation is still open.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The tax differential between following Section 482 transfer-pricing rules and Section 936 profit split rules would determine the revenue impact of this bill. Based on an analysis of the tax returns of corporations under audit for transfer pricing issues, tax differentials were approximated and grown 5% per year to the 2000 level. For subsequent years, losses were phased out to reflect the sunset of Section 936 for taxable years beginning after December 31, 2005. Estimated losses reflect the projected cash flow impact of reduced taxes plus any applicable interest for the initial three fiscal years beginning in 1999-00.

BOARD POSITION

Pending.